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DESCRIPTION OF EXPIRING TAX PROVISIONS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of certain tax provisions that expired in 1988 and of provisions scheduled to expire in 1989.[2]

The first part of the pamphlet is a summary listing of tax provisions that were extended by the Technical and Miscellaneous Revenue Act of 1988 and expired in 1988 and of tax provisions scheduled to expire in 1989. The second part provides a brief description of these expired and expiring tax provisions, including reference to recent legislative background.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Expiring Tax Provisions* (JCS–8–89), March 13, 1989.

[2] Several of these proposals are also described in Joint Committee on Taxation, *Summary of Revenue Provisions in President Bush's Fiscal Year 1990 Budget Proposal* (JCS–6–89), March 3, 1989.

I. SUMMARY

Expired tax provisions

The following tax provisions expired at the end of 1988, unless otherwise indicated:

(1) Rules for allocation and apportionment of research expenses (expired at the end of the fourth month of the taxpayer's first taxable year beginning after August 1, 1987);

(2) Exclusion for employer-provided educational assistance benefits; and

(3) Exclusion for group legal services benefits, and tax exemption for an organization providing group legal services or indemnification against the cost of legal services as part of a qualified group legal services plan.

Expiring tax provisions

The following tax provisions are scheduled to expire at the end of 1989:

(1) 20-percent tax credit for qualified research expenditures;

(2) Targeted jobs tax credit;

(3) 10-percent energy tax credits for solar and geothermal property, and 15-percent credit for ocean thermal property;

(4) Tax exemption for qualified mortgage bonds and election to issue mortgage credit certificates;

(5) Certain rules relating to financially troubled financial institutions (reorganizations, net operating losses, and FSLIC/FDIC assistance payments);

(6) Treatment of mutual fund shareholder expenses for purposes of the 2-percent floor on miscellaneous itemized deductions;

(7) Qualified small-issue bonds;

(8) Low-income housing tax credit;

(9) Deductibility of health insurance costs of self-employed individuals;

(10) The ESOP exception to the additional tax on early withdrawals from qualified retirement plans; and

(11) The $2 million exception to the generation-skipping transfer tax.

II. DESCRIPTION OF PROVISIONS

A. Expired Tax Provisions

1. Allocation and apportionment of research expenses (secs. 861(b), 862(b), and 863(b) of the Code)

Present Law [3]

In general

U.S. persons are taxable on their worldwide income, including their foreign income. A U.S. person that earns foreign income may incur foreign income tax. Subject to the applicable foreign tax credit limitations, such a person may credit foreign income taxes against its U.S. tax liability. The purpose of the foreign tax credit and the foreign tax credit limitations is to yield primary taxing jurisdiction over U.S. persons' foreign income to foreign governments, while retaining residual taxing jurisdiction over such income for the United States and ensuring that the full U.S. tax is paid on domestic income.

The foreign tax credit limitations operate by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into 2 categories: tax on U.S. source taxable income and tax on foreign source taxable income. Pre-credit U.S. tax on foreign source taxable income is further subdivided by limitation categories, or "baskets," of income. The pre-credit U.S. tax on any particular limitation category of foreign source income serves as the upper limit on credits for foreign taxes on that type of income.

Each foreign tax credit limitation equals total pre-credit U.S. tax times the ratio of the taxable income in that limitation category to worldwide taxable income. Foreign source taxable income equals foreign source gross income less the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any deductions which cannot definitely be allocated to some item or class of gross income (Code sec. 862(b)). Deductions allocated and apportioned to foreign source gross income must be further allocated or apportioned among the separate limitation categories of foreign source gross income in order to arrive at foreign source taxable income in any one limitation category. Finally, allocation and apportionment of deductions to U.S. source gross income determines the amount of taxpayer's U.S. source taxable income (sec. 861(b)).

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[3] Some of the provisions discussed in this section were treated more comprehensively in Part III of the April 2, 1987 pamphlet, prepared by the staff of the Joint Committee on Taxation for the Senate Committee on Finance, entitled Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716) (JCS-6-87).

The Code generally articulates only the broad principles of how expenses reduce U.S. and foreign source gross income, leaving the Treasury Department to provide detailed rules for the generally fact-specific task of allocating and apportioning expenses. The application of regulations to particular facts and circumstances, therefore, has a significant role in determining the proportions of taxpayers' worldwide taxable income that are treated as derived from foreign sources. These proportions control, in turn, the level of taxpayers' foreign tax credit limitations.

A taxpayer that has paid less foreign tax in each limitation category than the foreign tax credit limitation with respect to that category credits all of its foreign income tax against pre-credit U.S. tax (such a taxpayer is said to have "excess limit" in each of its limitation categories). If the rules for allocating and apportioning deductions are then changed to permit foreign source deductions to be converted to U.S. source deductions, with the result that a greater proportion of the taxpayer's worldwide taxable income is deemed to come from foreign sources, the change cannot decrease the taxpayer's U.S. tax liability on its worldwide income. A taxpayer that has paid foreign taxes in excess of one or more of its foreign tax credit limitations (that is, a taxpayer with "excess credits") cannot currently use all of its foreign income taxes as credits. In this case, a change in the allocation and apportionment rules may result in additional use of foreign tax credits, as follows: The conversion of a foreign source deduction to a U.S. source deduction converts an amount of U.S. source taxable income to foreign source taxable income, thus increasing the foreign tax credit limitation and reducing the taxpayer's current U.S. tax liability by approximately 34 cents for each dollar of deduction that is converted from foreign to U.S. source. Conversely, upon a change in the allocation rules that shifts deductions from U.S. to foreign income, a taxpayer with excess credits (or a taxpayer that previously had excess limit and finds itself, as a result of the rule change, with excess credits) may experience an increase in U.S. tax liability due to a reduction in the amount of its foreign income taxes that remain creditable.

Treasury Regulation sec. 1.861-8(e)(3)

Treasury Regulations promulgated in 1977 prescribe detailed rules for allocating and apportioning research and experimental expenses for purposes of computing the foreign tax credit limitation of a U.S. person, as well as for other purposes (Treas. Reg. sec. 1.861-8(e)(3)) ("the R&D regulation").[4]

The R&D regulation contemplates that taxpayers will sometimes undertake R&D solely to meet legal requirements. In some such cases, the R&D cannot reasonably be expected to generate income (beyond *de minimis* amounts) outside a single geographic source. If so, those deductible R&D expenses reduce gross income only from the geographic source that includes that jurisdiction.

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[4] By its terms, the R&D regulation would also apply, for example, in determining the U.S. source taxable income of a foreign person, and the taxable income effectively connected with a U.S. trade or business conducted by a foreign person, insofar as those determinations are necessary under other "operative" Code sections. The operative section for the foreign tax credit limitation is section 904(a).

After allocating deductions to meet legal requirements, the regulation generally allows 30 percent of deductible R&D expenses to reduce gross income from the source where over half of the taxpayer's total deductible R&D expenses are incurred. A taxpayer has the opportunity to apportion more than 30 percent of its R&D deduction exclusively to the source where R&D is performed if it can establish that a significantly higher percentage is warranted because the R&D is reasonably expected to have a very limited or long-delayed application outside that geographic source.

After a taxpayer makes a place-of-performance apportionment, it must apportion the amount of its R&D deduction remaining, if any, on the basis of relative amounts of domestic and foreign sales receipts. Subject to certain limitations, a taxpayer may elect to apportion its R&D deduction under an optional gross income method instead of the sales method. Under a gross income method, a taxpayer generally apportions its R&D deduction (after allocation under the legal requirements test but not the place-of-performance test) on the basis of relative amounts of gross income from domestic and foreign sources. The basic limitation on the use of optional gross income methods is that the respective portions of a taxpayer's R&D deduction apportioned to U.S. and foreign source income using a gross income method may not be less than 50 percent of the respective portions that would be apportioned to each such income grouping using the sales apportionment method (with the latter's exclusive place-of-performance allocation, typically 30 percent).

Legislative Background

Starting in 1981, Congress enacted a series of statutory R&D allocation rules to substitute, in part, for the R&D regulation. The first statutory R&D allocation rule was contained in the Economic Recovery Tax Act of 1981 (ERTA), covering any taxpayer's first 2 taxable years beginning within 2 years after August 13, 1981. In the taxable years governed by this aspect of ERTA, all U.S.-incurred R&D expenses were allocated to U.S.-source income. This provision was extended by the Deficit Reduction Act of 1984 (DEFRA) and the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) through taxable years beginning on or before August 1, 1986.

For taxable years beginning after August 1, 1986, and on or before August 1, 1987, the Tax Reform Act of 1986 (TRA) provided that 50 percent of research expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were allocated to U.S. source income, with the remainder allocated and apportioned either on the basis of sales or gross income. In contrast with the R&D regulation, the temporary rule of TRA (1) gave taxpayers using the gross sales method of apportionment an automatic place-of-performance allocation, for U.S.-incurred R&D, of 50 (rather than 30) percent; (2) allowed taxpayers using the gross income apportionment method to use the automatic place-of-performance rule; and (3) imposed no limit on the extent to which use of the gross income method could result in decreasing

the amount of R&D expenses that would otherwise be allocated to foreign source income using the gross sales method.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) effectively extended statutory allocation rules for an additional four months. The rules in effect for these four months, however, were different than those contained in previous statutes. Expenses incurred during the taxable year governed by TAMRA (for any taxpayer, its first taxable year beginning after August 1, 1987) were deemed to be incurred ratably throughout the year. For expenses deemed to have been incurred in the first four months of the year (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source), 64 percent of U.S.-incurred R&D expenses were allocated to U.S. source income, 64 percent of foreign-incurred R&D expenses were allocated to foreign source income, and the remainder of R&D expenses were allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment was used, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used. For expenses deemed to have been incurred during the remaining eight (or fewer) months of the year governed by TAMRA, the R&D allocation regulation applied.

There are no statutory R&D allocation and apportionment rules applicable to years governed by TAMRA. Thus, the R&D regulation generally governs allocation and apportionment of U.S.-incurred R&D expenses (as well as foreign-incurred R&D expenses) in all taxable years beginning after August 1, 1988.

2. Exclusion for employer-provided educational assistance (sec. 127 of the Code)

Prior Law

Under present law, an employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to an employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2 percent of the taxpayer's adjusted gross income. No deduction is allowed for expenses incurred to qualify for a new trade or business (e.g., for law school tuition paid by a paralegal or accountant).

Under prior law, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1988, was limited to $5,250 of educational assistance with respect to an individual during a calendar year. In addition, for taxable years beginning after 1987, the exclusion did not apply to graduate level courses. Specifically, the exclusion did not apply to any payment for, or the provision of any benefits with respect to, any course taken by an employee who had a bachelor's degree or was receiving credit toward a more advanced degree, if the particular course could be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.

Section 127 required, among other things, that educational assistance provided under such a program not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that if the section 127 exclusion for educational assistance were extended, the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion in lieu of the prior-law rules.

Legislative Background

The section 127 exclusion was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the Tax Reform Act of 1986 (through 1987), and by the Temporary and Miscellaneous Revenue Act of 1988 (through 1988, with the limitation that the exclusion does not apply to graduate level courses).

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3. Exclusion for employer-provided group legal services; tax exemption for qualified group legal services organizations (secs. 120 and 501(c)(20) of the Code)

Prior Law

Under prior law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) were excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). The exclusion was limited to an annual premium value of $70. In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill certain requirements. The exclusion for group legal services benefits expired for taxable years ending after December 31, 1988.

In addition, prior law provided tax-exempt status for an organization the exclusive function of which was to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan (sec. 501(c)(20)). The tax exemption for such an organization expired for taxable years ending after December 31, 1988.

Section 120 required, among other things, that group legal service benefits provided under a qualified plan not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion for group legal service benefits in lieu of the prior-law rules if the exclusion was extended for any period after the effective date of section 89.

In 1984, Congress required that employers file information returns with respect to qualified group legal services plans (sec. 6039D). This requirement was intended to collect data with respect to the use of such plans so that Congress could evaluate the effectiveness of the exclusion.

Legislative Background

The section 120 exclusion and the section 501(c)(20) exemption were enacted initially on a temporary basis by the Tax Reform Act of 1976 (through 1981). They subsequently were extended, again on a temporary basis, by the Economic Recovery Act of 1981 (through 1984), Public Law 98-612 (through 1985), the Tax Reform Act of 1986 (through 1987), and the Technical and Miscellaneous Revenue Act of 1988 (through 1988).

B. Tax Provisions Expiring in 1989

1. Tax credit for qualified research expenditures (sec. 41 of the Code)

Present Law

General rule

A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade or business. Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period, which generally is the preceding three taxable years.

Eligible expenditures

Research expenditures eligible for the 20-percent incremental credit under present law consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Under the 1986 Act, a 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.

The amount of credit-eligible basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Research definition

The 1986 Act provided statutory rules defining qualified research for purposes of the incremental credit. These rules target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the 1986 Act expressly excluded certain types of expenditures from eligibility for the credit, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs. The definitional modifications were effective for taxable years beginning after 1985.

Relation to deduction

For taxable years beginning prior to 1989, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures was not reduced by the amount of any credit allowed to the taxpayer for the same quali-

fied research expenditures. For taxable years beginning after 1988, however, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 50 percent of the taxpayer's section 41 credit determined for that year. A similar rule applies if the taxpayer capitalizes, rather than expenses, qualified research expenditures pursuant to section 174.

Computation of allowable credit

General rule.—The credit applies to the amount of qualified research expenditures for the current taxable year that exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

New businesses.—For a base period year during which it was not in existence, a new business is treated as having research expenditures of zero for purposes of computing average annual research expenditures during the base period. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule.—In computing the credit, the amount of base period research expenditures to be subtracted from current-year expenditures is treated as at least equal to 50 percent of the taxpayer's qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

Aggregation rules.—To ensure that the credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Changes in business ownership.—Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Trade or business limitations

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception relating to certain research joint ventures, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. Thus, for example, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner that is an operating company) for partnership expenditures for outside or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for

license or royalty payments. Under the trade or business test, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer.

Other limitations and carryover

The 1986 Act made the research credit subject to the general business credit limitation (i.e., 75 percent of tax liability over $25,000), effective for taxable years beginning after 1985. Any excess amount of the general business credit can be carried back three years and carried forward 15 years, beginning with the earliest year.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income that is allocable or apportionable to such interest. Any excess credit amount is eligible for the carryover rule described above.

Legislative Background

As enacted in the Economic Recovery Tax Act of 1981, the rate of the credit was 25 percent, and the credit was scheduled to expire after December 31, 1985. In the Tax Reform Act of 1986, the credit was extended for three years (i.e., for qualified research expenditures through December 31, 1988); also, the credit rate was reduced to 20 percent of the incremental research expenditure amount, effective for taxable years beginning after 1985.

The Technical and Miscellaneous Revenue Act of 1988 extended the credit for one additional year through December 31, 1989. The Act also reduced the deduction allowed under section 174 for qualified research expenditures by an amount equal to 50 percent of the taxpayer's research credit determined for the year.

2. Targeted jobs tax credit (sec. 51 of the Code)

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit claimed.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1990.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1989. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Legislative Background

Extension of credit, authorization of appropriations

The targeted jobs tax credit was enacted in the Revenue Act of 1978 to replace an expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year (through 1982), the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years (through 1984), and the Deficit Reduction Act of 1984 (the 1984 Act) for one year (through 1985).

The Tax Reform Act of 1986 extended the targeted jobs credit for three additional years (through 1988), with modifications. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) extended the credit with modifications for one additional year (through 1989).

TEFRA authorized appropriations for the expenses of administering the system, for certifying targeted group membership, and for providing publicity to employers regarding the targeted jobs credit. The 1984, 1986, and 1988 Acts successively extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1989.

Modification of credit

ERTA, TEFRA, and the 1984 Act modified the targeted group definitions and made several technical and administrative changes in the credit provisions.

The 1986 Act limited the extended credit in three respects: (1) a 25-percent credit for qualified wages paid in the second year of a targeted-group individual's employment was repealed; (2) a 50-percent credit for qualified first-year wages generally was reduced to a 40-percent credit (except that the credit allowed for wages of economically disadvantaged summer youth employees was retained at 85-percent of up to $3,000 of qualified first-year wages); and (3) no wages paid to a targeted-group member are taken into account for credit purposes unless the individual either (a) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (b) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Under the 1986 Act, the modified credit is available for wages paid to targeted-group individuals who begin work for an employer after December 31, 1985 and before January 1, 1989.

As a result of the Omnibus Budget Reconciliation Act of 1987, the credit is no longer available for wages paid to a targeted-group individual who performs the same or substantially similar services as an employee participating in, or affected by, a strike or lockout.

Two modifications were also made to the credit in TAMRA: (1) the category of economically disadvantaged youth was restricted to include employees age 18 to 22 rather than employees age 18 to 24, and (2) the credit percentage for disadvantaged summer youth employees was reduced from 85 percent to 40 percent.

3. Business energy tax credits for solar, geothermal, and ocean thermal property (secs. 46(a)(2) and 46(b)(2)(A)(viii), (ix), and (x) of the Code)

Present Law

A nonrefundable energy tax credit is allowed for certain investments in solar property, geothermal property, and ocean thermal property. For solar and geothermal properties, the rate of the credit is 10 percent in 1989. The rate of the credit for ocean thermal property is 15 percent in 1989. The energy tax credits for solar, geothermal, and ocean thermal properties are not available for properties placed in service after December 31, 1989.[5]

Legislative Background

The energy tax credits for solar and geothermal properties were enacted in the Energy Tax Act of 1978, effective through 1982. The credit for ocean thermal property was enacted in the Windfall Profit Tax Act of 1980, effective through 1985, and in the same act, the solar and geothermal credits were extended through December 31, 1985. In the Tax Reform Act of 1986, these three credits were extended for three additional years (through 1988) at rates which phased down to the present rates. The Technical and Miscellaneous Revenue Act of 1988 extended these credits for one additional year, through December 31, 1989.

[5] For definition of solar, geothermal, and ocean thermal property, see Code sections 48(l)(4), 48(l)(3)(A)(viii), and 48(l)(3)(A)(ix), respectively.

4. Qualified mortgage bonds and mortgage credit certificates (secs. 143 and 25 of the Code)

Present Law

Qualified mortgage bonds

In general, mortgage revenue bonds qualifying for tax-exemption under section 103 of the Code ("qualified mortgage bonds") are bonds the proceeds of which are used (net of costs of issuance and a reasonably required reserve fund) to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds.

First-time homebuyer requirement

An issue is a qualified mortgage issue only if at least 95 percent of the net proceeds of the issue are used to finance residences for mortgagors without present ownership interests in their principal residences during the three-year period before their respective mortgages are executed. This first-time homebuyer requirement does not apply to mortgagors of residences located in targeted areas (as described below), mortgagors who receive qualified home improvement loans, or mortgagors who receive qualified rehabilitation loans.

Income limitations

Qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent (100 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income.

An adjustment to the mortgagor's qualifying income limitation is made for high housing cost areas. For purposes of this provision, the applicable income limit for the mortgagor will be the highest of 115 percent (100 percent for families of fewer than three persons) of area median gross income, the adjusted income limit determined for high housing cost areas, or 115 percent (100 percent for families of fewer than three persons) of the State median gross income. Family income of mortgagors (as well as area median gross income) is to be determined by the Treasury Department after taking into account the regulations under section 8 of the United States Housing Act of 1937.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent (120 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income. The remaining one-third of the mortgage financing of each issue may be used to provide mortgage loans without regard to income limitations. A targeted area is defined as (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the Statewide median family income, or (2) an area of chronic economic dis-

tress designated by the Secretary of the Treasury and the Secretary of Housing and Urban Development.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence. The determination of average area purchase prices is made separately (1) with respect to new residences and existing, previously occupied residences, and (2) to the extent provided in regulations, with respect to one-, two-, three-, and four-family residences.

Loan origination and loan prepayment rules

All unspent proceeds remaining 3 years after the date of issuance of qualified mortgage revenue bonds must be used to redeem bonds within the next six months. The amount of any loans originated during that 6-month period will reduce the amount of bonds to be redeemed by the amount of such loans. Generally, the amounts of regular loan repayments and prepayments which are received ten years or more after the date the bonds are issued must be used to redeem bonds. A *de minimis* exemption of $250,000 is allowed from these redemption requirements. Repayments received during the 10-year period following original issuance may be used to make new loans.

Recapture

All or part of the subsidy provided by qualified mortgage revenue bond financing or mortgage credit certificates (described below) is recaptured on dispositions of assisted housing which occur within 10 years of purchase by mortgagors whose incomes increased substantially since purchase of their homes. The maximum amount recaptured is 1.25 percent of the original balance of the loan for each year the loan is outstanding, or 50 percent of the gain realized on the disposition, whichever is less. For sales in years six through 10, the 1.25 percent per year is phased out. This recapture provision only applies to loans originated, and mortgage credit certificates issued, after December 31, 1990.

Mortgage credit certificates

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for 10 to 50 percent of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the

dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds and that elects to exchange $100 million of that bond authority can distribute an aggregate amount of MCCs equal to $25 million.

Legislative Background

The Mortgage Subsidy Bond Act of 1980 imposed restrictions on the ability of State and local governments to issue tax-exempt bonds to finance mortgage loans on single-family, owner-occupied residences. The 1980 Act provided that interest on mortgage subsidy bonds would be exempt from taxation only if the bonds were "qualified veterans' mortgage bonds" or "qualified mortgage bonds."

The authority of State and local governments to issue tax-exempt qualified mortgage bonds under the 1980 Act expired on December 31, 1983. The Deficit Reduction Act of 1984 extended this authority (with modifications) through December 31, 1987.

The authority to issue qualified mortgage bonds and the election to trade in bond volume authority to issue MCCs were extended for one year, through December 31, 1988, by the Tax Reform Act of 1986, and for another year, through December 31, 1989, by the Technical and Miscellaneous Revenue Act of 1988.

5. Financially troubled financial institutions: reorganizations, NOLs, and FSLIC/FDIC assistance payments (secs. 368(a)(3)(D), 382(l)(5)(F), and 597 of the Code)

Present Law

Continuity of interest requirement

In order for the acquisition of a financially troubled financial institution to qualify as a tax-free reorganization, the acquisition must satisfy the judicially-created "continuity of interest" requirement. The continuity of interest doctrine generally requires that the shareholders of an acquired corporation maintain a meaningful ownership interest in the acquiring corporation in order for the transaction to qualify as a tax-free "reorganization" within the meaning of section 368(a). Without special reorganization rules (described below), there is often uncertainty under what circumstances the continuity of interest requirement is met, especially in the case of mutually-owned thrift institutions.

A special rule adopted in the Economic Recovery Tax Act of 1981 (the "1981 Act") provides that the continuity of interest requirement need not be satisfied in the case of certain mergers involving financially troubled thrift institutions. In the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), this special rule was expanded to cover certain mergers of financially troubled banks.

Under present law, a merger involving a financially troubled financial institution need not satisfy the continuity of interest requirement provided the following three requirements are met (sec. 368(a)(3)(D)). First, the acquired institution must be one to which section 593 (a savings and loan association, a cooperative bank, or a mutual savings bank) or section 585 (a bank) applies. Second, a certification that the acquired financial institution is financially troubled must be issued by the specified organization having supervisory authority over the financial institution. Third, substantially all the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization under section 368(a)(1)(D).

Net operating loss carryovers

In a tax-free reorganization, the acquiring corporation generally succeeds to the tax attributes of the acquired corporation, including its net operating and built-in loss carryovers, subject to certain limitations contained in section 382. Under the rules providing limitations on net operating loss carryovers before the Tax Reform Act of 1986 ("old section 382"), the net operating loss carryovers of a corporation were reduced if the shareholders of the corporation with the net operating loss carryover did not own at least 20 percent of the stock in the corporation surviving the reorganization. The Tax Reform Act of 1986 (the "1986 Act") revised these limitations on net operating and built-in loss carryovers. In general, under present-law section 382, the ability of an acquiring corporation to utilize to the net operating and built-in loss carryovers of a corporation acquired in a tax-free reorganization is limited if there has

been more than a 50-percent change in the ownership of the acquired corporation.

The 1981 Act contained a special rule which relaxed the loss limitation provisions of old section 382 applicable to tax-free reorganizations involving financially troubled thrift institutions. The 1986 Act continued to provide a similar special rule under present-law section 382 for financially troubled thrift institutions. The 1988 Act expanded this special rule to cover tax-free reorganizations of financially troubled banks.

Under present law, in the case of a tax-free acquisition of a financially troubled financial institution, the depositors of such institution whose deposits are assumed by the acquiring corporation are deemed to continue an equity interest in the reorganized financial institution. In addition, the percentage ownership that must be retained so as not to trigger the application of the limitation on losses under section 382 is reduced from 50 percent to 20 percent (sec. 382(l)(5)(F)).

Assistance payments to financially troubled financial institutions

Under general tax principles, the tax treatment of payments from the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC) to a financial institution is unclear. A payment can be treated as gross income to the recipient financial institution or otherwise reduce the amount of any insured loss. Alternatively, taxpayers may take the postition that a payment is a contribution to the capital of the financial institution, in which case it would not be includible in gross income (sec. 118). If the payment is characterized as a contribution to capital, the tax consequences would vary depending upon whether the payment was treated as a non-shareholder or shareholder contribution to capital. If characterized as a non-shareholder contribution to capital, the basis of property held by the recipient financial institution normally would be reduced by the amount of such contribution (sec. 362(c)). If characterized as a shareholder contribution to capital, there would be no basis adjustment.

The 1981 Act provided that financially troubled thrift institutions may exclude financial assistance by the FSLIC from income and need not reduce their basis in property by the amount of such financial assistance (sec. 597). In the 1988 Act, this special rule was expanded to provide that financially troubled banks may exclude financial assistance by the FDIC from income and need not reduce their basis in property by the amount of such financial assistance. In addition, the 1988 Act provided, in general, for a reduction in certain tax attributes of a financially troubled financial institution equal to 50 percent of the amount of assistance provided by the FSLIC or the FDIC and excluded from the gross income of the financial institution under section 597.

Legislative Background

The Economic Recovery Tax Act of 1981 provided special rules applicable to financially troubled thrift institutions (described above). The Tax Reform Act of 1986 provided that the special rules would terminate at the end of 1988. The Technical and Miscellaneous Revenue Act of 1988 extended for one year (through 1989) the

effective date of the repeal of these provisions and made certain modifications to the provisions, including the extension of these provisions to financially troubled banks.

6. Treatment of mutual fund shareholder expenses for purposes of the 2-percent floor on miscellaneous itemized deductions (sec. 67(c) of the Code)

Present Law

Miscellaneous employee and investment expenses generally are deductible by itemizers only to the extent that they exceed 2-percent of the taxpayer's adjusted gross income. Investment expenses indirectly incurred by a taxpayer through a pass-through entity, such as a mutual fund, do not directly reduce the amount of the entity's income that is taxable to the taxpayer, but are deducted by the taxpayer as miscellaneous deductions subject to the 2-percent floor.

In the Technical and Miscellaneous Revenue Act of 1988, Congress intended to exclude certain mutual fund expenses from miscellaneous itemized duductions subject to the 2-percent floor until taxable years beginning after December 31, 1989.[6] Because of a drafting error, mutual fund expenses were indefinitely excluded from miscellaneous itemized deductions. Accordingly, a technical correction may be required to reflect Congressional intent that mutual fund expenses be included in miscellaneous itemized deductions subject to the 2-percent floor in taxable years beginning after December 31, 1989.

Legislative Background

The Tax Reform Act of 1986 would have treated certain investment expenses of publicly offered mutual funds as miscellaneous itemized deductions (subject to the 2-percent floor) for taxable years beginning after December 31, 1986. The Omnibus Budget Reconciliation Act of 1987 delayed such treatment until taxable years beginning after December 31, 1987. Under the Technical and Miscellaneous Revenue Act of 1988, such treatment would not occur in taxable years beginning prior to January 1, 1989.

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[6] H. Rep. 100-1104, Vol. II (October 21, 1988) p. 92 (Conference Report).

7. Qualified small-issue bonds (sec. 144(a) of the Code)

Present Law

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the bond proceeds is used to finance manufacturing facilities or certain land or property for first-time farmers ("qualified small-issue bonds").

Qualified small-issue bonds are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Special limits apply to bonds for first-time farmers. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the 6-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10-million limitation, capital expenditures during a 6-year period) are taken into account if (1) they are used with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the qualified small-issue bonds, and (2) the principal users of both facilities are the same, or two or more related persons.

The aggregate amount of qualified small-issue bond financing for all types of depreciable farm property (including both new and used property) is limited to $250,000 for any person or related persons. The $250,000 is a lifetime limit.

Capital expenditures not included for purposes of the $10 million limit are expenditures (1) made to replace property destroyed or damaged by fire, storm, or other casualty; (2) required by a change in Federal, State, or local law made after the date of issue; (3) subject to a $1 million limit, required by circumstances that reasonably could not be foreseen on the date of issue; or (4) qualifying as in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

Interest on qualified small-issue bonds is taxable if the aggregate face amount of all outstanding tax-exempt private activity bonds (including exempt-facility bonds, qualified redevelopment bonds, and qualified small-issue bonds) that would be allocated to any beneficiary (other than a section 501(c)(3) organization) of the qualified small-issue bonds exceeds $40 million. Bonds that are to be redeemed with the proceeds of a new issue (other than in an advance refunding) are not considered. Certain current refunding bonds are also not taken into account.

For purposes of the $40 million limitation, the face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a 3-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns bond-financed property and other persons are principal users, or when owners and/or principal users change during the 3-year test period. Once an allocation to a test-period beneficiary is made, that allocation remains in

effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property. If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of qualified small-issue bonds that caused the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other previously issued qualified small-issue bonds is not affected.

Legislative Background

Substantial modifications to the tax treatment of exempt small-issue industrial development bonds (IDBs) were made by the Tax Equity and Fiscal Responsibility Act of 1982. The 1982 Act also provided that the authority to issue exempt small-issue IDBs would sunset on December 31, 1986. The Tax Reform Act of 1986 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities and certain land or property for first-time farmers to December 31, 1988. The Technical and Miscellaneous Revenue Act of 1988 generally extended that sunset date to December 31, 1989. Current refundings of qualified small-issue bonds may be issued after December 31, 1989, provided that the refunding bonds (1) do not have a weighted average maturity in excess of the weighted average maturity of the refunded issue, (2) have a lower interest rate than the rate on the refunded bonds, and (3) are in an amount that does not exceed the outstanding amount of the refunded bonds.

8. Low-income housing tax credit (sec. 42 of the Code)

Present Law

A credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed, substantially rehabilitated, or newly acquired existing residential rental property. For buildings placed in service after 1987, the credit percentages are adjusted monthly for buildings placed in service to maintain a present value of the credit stream of 70 percent for qualified expenditures for most newly constructed and rehabilitated housing. In the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies (including tax-exempt bonds), monthly adjustments are made to maintain a 30 percent present value for the credit.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. A residential rental project qualifies for the low-income housing credit only if (1) 20 percent or more of the aggregate residential rental units are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size. Rents charged to families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low," adjusted for family size. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credit may be recaptured.

Credit allocation is granted by State or local government credit authorities subject to an annual limitation ($1.25 per resident) for each State. In order for a building to be a qualified low-income building, the building owner must receive a credit allocation from the appropriate credit authority, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. A building must be placed in service in the year in which a credit allocation is received from the credit authority or in either of the succeeding two years provided that, by the end of the year in which the credit allocation is made, the taxpayer's basis (land and depreciable basis) in the project of which the building is a part is more than 10 percent of the taxpayer's reasonably expected basis in such project.

Legislative Background

The low-income housing credit was enacted by the Tax Reform Act of 1986 with a sunset date of December 31, 1989.

9. Deductibility of health insurance costs of self-employed individuals (sec. 162(l) of the Code)

Present Law

Under present law, an employer's contribution to a plan providing accident or health coverage is excludable from an employee's income (sec. 106). No equivalent exclusion is provided for self-employed individuals (i.e., sole proprietors or partners in a partnership).

However, present law provides a deduction for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual is an individual who has earned income for the taxable year (sec. 401(c)(1)). However, no deduction is allowable to the extent the deduction exceeds the self-employed individual's earned income for the taxable year. In addition, no deduction is allowable for any taxable year in which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual (or of such individual's spouse).

The deduction is allowable if the nondiscrimination requirements applicable to employer-provided accident and health plans (sec. 89) are satisfied with respect to the plan for which the 25-percent deduction is allowable.

The amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.

Legislative Background

The 25-percent deduction for the health insurance costs of self-employed individuals was enacted on a temporary basis by the Tax Reform Act of 1986 (for taxable years beginning before January 1, 1990). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988.

10. ESOP exception to additional tax on early withdrawals from qualified retirement plans (sec. 72(t) of the Code)

Present Law

Under present law, an additional 10-percent income tax applies to early withdrawals from a qualified retirement plan. However, certain distributions from an employee stock ownership plan (ESOP) or a tax credit ESOP are exempt from the additional income tax. This exception is available to the extent that the distributions are attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy certain requirements (secs. 409 and 401(a)(28)) for the 5-year period immediately preceding the plan year in which the distribution occurs.

Legislative Background

The 10-percent additional income tax on early withdrawals and the ESOP exception to the tax were enacted on a temporary basis by the Tax Reform Act of 1986 (through December 31, 1989). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988.

11. $2 million exclusion from generation-skipping transfer tax (sec. 1433(b)(3) of the Tax Reform Act of 1986)

Present Law

A generation-skipping transfer tax is generally imposed on transfers by gift or bequest to grandchildren. Certain transfers aggregating less than $2 million made to grandchildren before January 1, 1990 are excluded from the tax.

Legislative Background

The $2 million exclusion was enacted in the Tax Reform Act of 1986.

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ERRATA

The following changes should be made to Description of Expiring Tax Provisions, published by the staff of the Joint Committee on Taxation on March 13, 1989, as JCS-8-89.

(1) On page 7, the first sentence of the last paragraph should read as follows: There are no statutory R&D allocation and apportionment rules applicable to years after the year governed by TAMRA.

(2) On page 23, the date in the last sentence of the last paragraph should be changed from January 1, 1989 to January 1, 1990.

(3) On page 25, the third and fourth sentences of the last paragraph should read as follows: The Deficit Reduction Act of 1984 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities to December 31, 1988. The Tax Reform Act of 1986 extended that sunset date to December 31, 1989.

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